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3M's (MMM) CEO Michael Roman on Q2 2019 Results - Earnings Call Transcript

Jul. 25, 2019 4:02 PM ET
by: SA Transcripts

Q2: 07-25-19 Earnings Summary

Press Release *Slides*

EPS of $2.2 beats by $0.13 | Revenue of $8.17B (-2.61% Y/Y) beats by $66.1M

Earning Call Audio Subscribers Only

0:00 / 2:06:35

3M Company (NYSE:MMM) Q2 2019 Earnings Conference Call July 25, 2019 9:00 AM ET

Company Participants

Bruce Jermeland – Vice President-Investor Relations

Mike Roman – Chairman and Chief Executive Officer

Nick Gangestad – Chief Financial Officer

Conference Call Participants

Andrew Kaplowitz – Citi

Joe Ritchie – Goldman Sachs

Andrew Obin – Bank of Merrill Lynch

Julian Mitchell – Barclays

Nigel Coe – Wolfe Research

Josh Pokrzywinski – Morgan Stanley

Steve Tusa – JP Morgan

Deane Dray – RBC Capital Markets

John Inch – Gordon Haskett

John Walsh – Credit Suisse

Laurence Alexander – Jefferies

Jeff Sprague – Vertical Research Partners

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the 3M Second Quarter Earnings Conference Call. During the presentation, all participants will be in a listen-only mode. Afterwards, we will conduct a question-and-answer session. [Operator Instructions] As a reminder, this conference is being recorded, Thursday, July 25, 2019.

I would now like to turn the call over to Bruce Jermeland, Vice President of Investor Relations at 3M.

Bruce Jermeland

Thank you, and good morning, everyone. Welcome to our second quarter 2019 business review. With me today are Mike Roman, 3M's Chairman and Chief Executive Officer; and Nick Gangestad, our Chief Financial Officer. Mike and Nick will make some formal comments, and then we'll take your questions.

Today's earnings release and slide presentation accompanying this call are posted on our Investor Relations website at 3m.com under the heading, Quarterly Earnings.

Please note we are reporting our results under our new business group structures starting with the second quarter. Additional business group performance details can be found in the appendix of this presentation along with our May 30th, 8-K and our Investor Relations website.

Lastly, let me remind you and mark your calendars for our third quarter earnings call which will take place on Thursday, October 24th.

Please take a moment to read the forward-looking statement on Slide 2.

During today's conference call, we will make certain predictive statements that reflect our current views about 3M's future performance and financial results. These statements are based on certain assumptions and expectations of future events that are subject to risks

and uncertainties. Item 1A of our most recent Form 10-K lists some of the most important risk factors that could cause actual results to differ from our predictions.

Finally, please note that throughout today's presentation, we will be making references to certain non-GAAP financial measures, in particular, measures which exclude the impact of the deconsolidation of our Venezuelan subsidiary. Reconciliations of the non-GAAP measures can be found in the appendix of today's presentation and press release.

Please turn to Slide 3, and I'll hand it off to Mike. Mike?

Mike Roman

Thank you, Bruce. Good morning, everyone, and thank you for joining us. I am encouraged by our company's progress and performance in the second quarter, coming off a difficult to start to the year. While we continued to face slow growth conditions in key end markets, our execution was strong. We implemented our restructuring while effectively managing costs and reducing inventory levels, which I will discuss on the next slide.

Our team is building momentum going into the second half as we focused on what we control and as a result today we are affirming our guidance for the full year. At the same time, we remain focused on our four priorities for long-term value creation, portfolio, transformation, innovation and people and culture.

In the second quarter, this included our acquisition of Acelity, an excellent complement to our health care portfolio and which we expect to close in the fourth quarter.

Please turn to Slide 4. As you recall on our last earnings call, we laid out specific and aggressive actions to strengthen our performance. In the second quarter, we made significant progress with each of those actions. First, the restructuring has been finalized across the enterprise, which resulted in a pre-tax charge of $148 million.

We continue to expect annual savings of $225 million to $250 million with $110 million in the remainder of this year. Beyond the restructuring, we are driving increased cash flow through several other actions. For example, we adjusted our manufacturing output and reduced inventory levels by over $250 million in the quarter. We also curtailed indirect costs by more than $80 million year-over-year.

While we are making positive strides in our operations, there is still more to do and we will remain focused on managing costs and improving productivity. As we do this, we will continue to invest in organic growth, the research and development and CapEx to deliver

on our promise to innovate for our customers.

Please turn to Slide 5 for a summary of our second quarter. Organic growth companywide was minus 1% in line with our expectations. Growth was led by our Health Care business at 4% which was a good improvement versus Q1 and consumer grew 1%. We saw continued end market softness in China, automotive and electronics, which tempered growth in our other two businesses.

Growth in Safety and Industrial declined by 5%, while Transportation and Electronics was down 1%. With respect to EPS, we posted adjusted earnings of $2.20 per share, which includes a $0.21 charge for restructuring and a $0.07 benefit from a pending divestiture, which Nick will cover in his remarks.

Underlying margins were 22.2% which excludes 140 basis points of impact from the restructuring. So we are making good progress relative to our Q1 margins, up 21.4%. Importantly, we delivered this improved margin performance even while reducing production and inventory, which reflects the strength of the 3M value model.

I wanted to take this opportunity to thank our people for rising to the occasion and for executing our plans with focus and urgency. And while there is more work left to do, 3M's foundation remains strong. We have deep competitive advantages [indiscernible] advanced manufacturing, global capabilities and leading brands.

We have market leading businesses and strong relationships with our customers. Moving ahead, we are focused on investing for the future and continuing to deliver operational improvements which will enable us to better serve our customers and maximize value for all of our stakeholders. That wraps up my opening comments. I will come back to discuss our guidance after Nick takes you through the details of the quarter. Nick?

Nick Gangestad

Thank you, Mike, and good morning everyone. Please turn to Slide 6. Second quarter organic sales declined 0.9% in line with our expectations. Volumes were down 140 basis points while selling prices were up 50 basis points.

The net impact of acquisitions and divestitures increased sales by 10 basis points. While foreign currency translation was a 180 basis point headwind to sales. All in, second quarter sales in U.S. dollars declined 2.6% versus last year.

Looking at growth geographically, the U.S. was flat organically versus last year's 6% comparison. Last year's second quarter was boosted by increased customer demand ahead of our U.S. ERP go-live. Health Care grew mid single digits with Consumer up low single digits. Transportation and Electronics was flat while Safety and Industrial declined. Asia Pacific declined 90 basis points in Q2 with Health Care delivering positive mid single digit organic growth [indiscernible] while each organic growth in China was down 80 basis points with growth in Health Care and Transportation and Electronics, which was more than offset by declines in Safety and Industrial and Consumer.

For the year, we now expect organic growth in China to be down low to mid single digits versus a prior expectation of flat. As we continue to experience challenging end market conditions, particularly in the electronics and automotive industries.

EMEA declined 3.6% on a nearly 6% comparison in last year's second quarter. Latin America/Canada grew 70 basis points with Brazil, Canada, and Mexico each up low single digits.

Please turn to Slide 7 for the second quarter P&L highlights. Companywide, second quarter sales were $8.2 billion with operating income of $1.7 billion. Operating margins were 20.8% which included a 140 basis point impact from our second quarter restructuring and other actions.

As anticipated, the biggest impact to Q2 operating margins was the year on year decline in organic volume along with cost absorption penalties from lower production volumes as all business groups work to reduce inventories in the quarter. These factors resulted in a 200 basis point reduction to margins versus last year's second quarter.

Acquisitions and divestitures combined brought down margins by 50 basis points primarily due to the acquisition of M*Modal. Higher selling prices continued to more than offset raw material inflation contributing 30 basis points to second quarter margins. For the year, we continue to expect selling prices to more than offset raw material costs. And finally foreign currency net of hedging impacts increased margins by 40 basis points.

Let's now turn to Slide 8 for a closer look at earnings per share. Second quarter adjusted earnings were $2.20 per share. That was a bit better than we anticipated, primarily due to improved productivity along with the held for sales status related to a pending divestiture, which I will cover shortly.

Let me now cover the reconciling items to second quarter earnings. Negative organic growth along with absorption penalties from lower production and inventory levels reduced per share earnings by $0.19 [indiscernible] divestitures combined increased second quarter earnings by $0.01 per share versus last year. This result includes a $0.07 tax benefit related to the held per sales status of the pending divestitures of the gas and flame detection business that we announced in June.

Restructuring and other actions lowered Q2 earnings per share by $0.21. Our second quarter underlying tax rate was higher year on year, which decreased earnings by $0.07 per share.

And finally, we reduced average diluted shares outstanding by 3% versus Q2 last year, which added $0.07 to per share earnings.

Please turn to Slide 9 for a look at our cash flow performance. Second quarter free cash flow was $1.2 billion with a free cash flow conversion rate of 110% which includes a 14 percentage point benefit from the deconsolidation of our Venezuelan subsidiary.

Second quarter capital expenditures were $421 million, up $56 million year-on-year. For the full year, we continue to anticipate CapEx investments in the range of $1.6 billion to $1.7 billion.

During the quarter, we paid $830 million in cash dividends to shareholders and returned $400 million to shareholders through growth share repurchases. We continued to expect full year repurchases to be in the range of $1 billion to $1.5 billion.

Please turn to Slide 10, where I will summarize the business group performance for Q2. I will start with our Safety and Industrial business which declined 5% in the quarter. Similar to first quarter, we saw continued broad based softness and channel inventory reductions across most of the portfolio.

These factors particularly impacted our automotive aftermarket, abrasives and closure and masking systems businesses. Personal safety was up low single digits in Q2 against the double digit comparison a year ago. And roofing granules turn positive this quarter, growing low single digits organically.

Looking geographically, Safety and Industrial’s organic growth was led by a 1% increase in Latin America/Canada, well Asia Pacific, EMEA and the U.S. each declined. Safety and Industrial’s second quarter operating margins were 22.1% with an underlying decline of

approximately 200 basis points. Margins were impacted by negative organic growth, reductions in manufacturing output and inventory along with our second quarter restructuring actions.

Moving to Transportation and Electronics. Second quarter sales were down 120 basis points organically compared to last year. The electronics-related businesses were down low single digits organically with growth in display materials systems more than offset by declines in electronics materials solutions.

Our automotive OEM business was down 5% year on year impacted by a 7% decline in second quarter global car and last year strong comp. Transportation safety was up mid single digits and advanced materials continued to deliver strong organic growth up high single digits in the quarter.

Geographically, organic growth was flat in both the U.S. and Latin America/Canada, well Asia Pacific and EMEA declined. Transportation and Electronics second quarter operating margins were 24.1%, down 240 basis points. Similar to Safety and Industrial, margins were impacted by manufacturing and inventory reductions along with a 30 basis point impact from restructuring.

Turning to Health Care, as anticipated, this business improved versus first quarter as our team delivered 3.5% organic growth in Q2. Organic growth was broad across most of our Health Care business, led by a high single digit increase in health information systems.

Medical solutions, our largest business in Health Care was up mid single digits and we continue to look forward to Acelity becoming part of this business later this year, up low single digits.

Finally, drug delivery was down mid single digits in line with our expectations. On a geographic basis, Asia Pacific and the U.S. led the way each up mid single digits. Health Care second quarter operating margins were 26.4% which included a combined 210 basis point impact from the M*Modal acquisition and restructuring.

Lastly, second quarter organic growth for our Consumer business was nearly 1%. Sales grew low single digits in Consumer Health Care, stationery and office and home improvement. While home care declined.

Looking at Consumer geographically, organic growth was led by a 2% increase in the U.S. and Latin America/Canada, while Asia Pacific and EMEA declined. Consumers operating margins were 20.6% in the second quarter which included a 40 basis point impact from restructuring.

That wraps up our review of second quarter results. Please turn to slide 11 and I'll hand it back over to Mike to discuss 2019 guidance. Mike?

Mike Roman

Thank you, Nick. Today, we are affirming our guidance for the full year. We expect organic growth of minus one to plus 2% along with adjusted earnings of $9.25 to $9.75 per share. Please note that this guidance does not include the pending Acelity acquisition or the pending divestiture of our gas and flame detection business. We also continue to expect a return on invested capital of 20% to 22%. And a free cash flow conversion rate of 95% to 105%. While there is uncertainty in the global macroeconomic environment, we are maintaining our guidance, as we will see continued momentum from the actions we implemented in the first half.

[Indiscernible] PFAS, specifically, PFOA and PFOS, which are the subject of a litigation we face. As CEO, there are few things that I want people to know about this issue and our company.

First, 3M voluntarily phased out of the production of PFOA and PFOS in the early 2000s and was the first company to do so. Since then, we have been committed to using our expertise and resources to improve the knowledge of PFAS, support remediation and give people confidence in their water.

3M has invested $100 million in testing water sources. We have invested another $50 million for filtration systems as these substances can be effectively removed, which 3M has been doing for more than a decade. We have entered into voluntary agreements with states and communities where we manufactured these compounds.

We have also contributed to peer-reviewed journals, backed by hundreds of studies conducted by 3M and other researchers on the potential effects of PFAS. At the same time, we are continuing to work with the EPA along with state and local governments to support thoughtful regulations and solutions based on science and facts.

We also believe that an independent scientific body should partner with regulators to review all available [indiscernible] continues to evolve. The scientific evidence does not show that PFAS caused harm to people at past or current exposure levels. More broadly speaking, being an environmentally responsible company is core to 3M. We started our groundbreaking Pollution Prevention Pays program more than 40 years ago and we continue to step up our leadership to address climate and environmental challenges.

Earlier this year, we committed to move our entire global operations to renewable energy. And last year alone, 3M solutions helped our customers avoid 15 million tons of emissions. Sustainability is a value that matters deeply to our people, to our customers, and to me personally. It is a point of pride for 3M and we will defend with vigor our company's reputation in the court of law and in the court of public opinion.

That concludes our prepared remarks and we'll now take your questions.

Question-and-Answer Session

Operator

[Operator Instructions] And our first question comes from the line of Andrew Kaplowitz of Citi. Please proceed with your question.

Andrew Kaplowitz

Hey, good morning guys.

Mike Roman

Good morning, Andy.

Nick Gangestad

Good morning, Andy.

Andrew Kaplowitz

Mike or Nick, can you talk about the cadence of the quarter as it went on? Some industrial companies have talked about a bit of a stabilization late in Q2, did you see that at all in Safety and Industrial, Transportation and Electronics, and last quarter you said these stockings from your customers cost you something like a 100 basis points of revenue growth was similar impact in Q2 as it does look like your auto OEM business performed a bit better than the underlying market. So have you seen any signs of industrial or auto destocking this closer to ending?

Nick Gangestad

Yes, Andy. Throughout the quarter, the trends were pretty stable as we saw our sales progress through each of the three months. I can't say we really discerned any positive or negative trend as the quarter progressed. If I shift it internally, we did see our momentum

in terms of reducing in regards to channel inventory I said about last quarter about 100 basis points of what we impacted channel destocking.

We were again seeing channel destocking impacting us in the second quarter in particular in the SIBG business, safety and industrial business group. We think that was a very similar destocking impact to what we saw in the first quarter and as far as automotive, we were in most noticeably impacted by destocking in China and that just was not the same event in the second quarter. It was a pretty much more normal relation of auto builds to our penetration and less channel destocking going on in relation to auto.

Andrew Kaplowitz

Okay. Nick, that’s helpful. And then you mentioned in the presentation that you’ll save $110 million in the second half of the year $0.15. It will help to have a decent step-up in EPS in the second half even outside the benefit to make the midpoint of your guide. So how much of the step-up is in your control? Can you give us some more color on how much of your business transformation and stocking optimization initiatives can help you in the second half? I think there'll be programs in terms of savings that are continuing to ramp in second half and in 2020.

Nick Gangestad

Yes. Andy, a few things are going on. First of all, we have been progressively taking more and more inventory out of our own operations. We think some of that that’s going continue into the second half of the year. So that will continue to be a headwind that we are facing in the second half of the year. We will be getting the restructuring benefits of $0.15 that we talked about as well as I’ll just say overall disciplined cost management in light of what we would call a slowing economy right now.

So some of that our own discipline in execution will be impacting us in the second half. On the margin, there are some other things that will impact us. FX, which has been a neutral to a headwind in the second – in the first half of the year, that will be likely if FX rates stay where they are, that they will be coming positive to us in the second half of the year. But mainly it’s just going to be improved execution over what we saw in particularly in the first quarter.

Andrew Kaplowitz

Thanks Nick.

Nick Gangestad

Thanks Andy.

Operator

Our next question comes from the line of Joe Ritchie of Goldman Sachs. Please proceed with your question.

Joe Ritchie

Thanks. Good morning, everyone.

Mike Roman

Good morning, Joe.

Nick Gangestad

Good morning, Joe.

Joe Ritchie

Hey Nick. Maybe just kind of staying on the – how to think about the margins for the rest of the year, obviously, like a big headwind this quarter was the manufacturing and inventory reductions. And you guys have given some estimates for what you expect, productivity to be like this year and clearly, you are also moving ahead with indirect cost reduction. So I don't know, is the right way to think about it as you progress through the year that these things are going to offset each other? Or should we be thinking about them as a tailwind? I'm just trying to understand how to think this through.

Nick Gangestad

Joe, if I think about where we are going to end for the full year, let me just start out by saying when I look at collectively where all the sell-side analysts are in their view of the total year. My view is it looks like you collectively have it dialed in about right. What I'm seeing collectively amongst all of you means it lines up very closely with our own internal view of how things will progress for the full year.

If I look at in particular in Q3, Joe, right now we are expecting organic growth in the second quarter to be somewhere between flat to a low single digit organic growth. And as far as margins, what we've been seeing happen throughout the year and what we expect to continue to happen as we progress into Q3, Q1 to Q2, absent the restructuring actions, was a sequential improvement in margins as we focus on execution.

We think that sequential improvement going into Q3 is going to continue. So we expect our margins to be 23% or higher in the third quarter. And so what we are seeing there is some momentum building on our margin story. And so I'd say, Joe, those are the headlines to think about and how you are thinking about the second half of the year.

Joe Ritchie

Got it. That's super helpful, Nick. And I guess maybe, Mike, very, very helpful, commentary earlier on PFAS. I guess just as – obviously, it's hard to assess how this all shakes out, but I'd be curious to get your views on like timing on when we could think about when we'll start to get some sort of resolution, as it continues obviously to be a bit of an overhang on the shares?

Mike Roman

Yes. Joe, I wouldn't think about timing. In respect to timing, let me kind of talk about what we can say today. And it's not a lot, but it'll give you a couple of things to look at. The first trial, if there is a trial, related to the Wolverine cases in Michigan that would be at the end of first quarter. These are kind of fuzzy time lines. They're not fixed. But that's kind of the expectation when the first trials related that if there is a trial would come to us. AFFF, the MDL, the multi-district litigation, we wouldn't expect any actions on that until late 2020. So those are kind of a frame of the litigation and timing. And as we learn more – as I said in my comments, we're gaining and understanding all the time. And as we learn more, we'll update you as we go.

Joe Ritchie

Okay. Thank you.

Operator

Our next question comes from the line of Andrew Obin of Bank of Merrill Lynch, please proceed with your question.

Andrew Obin

Good morning. Can you hear me?

Mike Roman

Yes good morning, Andrew.

Andrew Obin

Yes. Just a couple of follow-up questions. Could you just walk us through core gross margins ex restructuring sequentially versus the first quarter and how should we think about progression on that side of the equation through the year? Thank you. That’s the first question.

Nick Gangestad

Okay, Andrew. A little bit of this will be a repeat from what I said to Joe, but our core underlying margins…

Andrew Obin

Gross margin, yes.

Nick Gangestad

Gross margin. Thank you for clarifying that Andrew. So our gross margins in the first quarter if we pull out the costs related to some litigation activity that we had in the first quarter, our core underlying gross margin was 48%. In the second quarter that went down. If I pull out the restructuring down to 47.5%, and that's being impacted, we think we estimate by a 100 basis points to 150 basis points in the second quarter by the aggressive actions we're taking and pulling out inventory in our production. So underlying operations, we're seeing good execution on what we're working there. And we expect those gross margins to continue to be impacted by us taking actions on our inventory. But we also do see our gross margins improving slightly into the third quarter.

Andrew Obin

So if we pull that out, just to clarify, if we pull that out, you're sort of recovering slowly from that 48% into sort of more historical range of 49%, 50%. That's a fair statement if you take out inventory,

Mike Roman

Andrew that's a fair statement.

Andrew Obin

And then on inventory, I assume that improved free cash flow forecast for the, I think, it's Slide 23 upon Slide 24, that's all working capital, right?

Mike Roman

Yes, we’re keeping our projection of free cash flow conversion. Well I think you're actually going into a deeper slide. Improved working capital is the biggest thing impacting our free cash flow conversion and dollars for 2019.

Andrew Obin

And if you were to quantify how much incremental working capital reduction opportunities do you have for the next 12 to 18 months?

Mike Roman

I'll isolate it just to inventory, right now, Andrew, in answering that question, 250 that we took out in the second quarter, we think there's another $100 million or $200 million that we can be taken out of the second half of 2019. And then as far as 2020, it's a little early to say, but we've been targeting to get down to 85 days of inventory outstanding. That's where we're targeting to get to the end of this year. If we're going to bring that down further in 2020, I’ll likely be giving that guidance later in this year or early next year.

Andrew Obin

Thank you very much.

Operator

Our next question comes from the line of Julian Mitchell of Barclays. Please proceed with your question.

Julian Mitchell

Hi. Good morning. Thank you.

Nick Gangestad

Hey Julian.

Mike Roman

Hey Julian.

Julian Mitchell

Hi. Maybe just focusing on Q3, so I think you talked about flat to slight organic sales growth firm wide. Maybe just help with a couple of aspects of that. One would be, does that assume further channel destocking and how severe would that be in Q3? Not your

own under production efforts, but that channel destock. And then what are you assuming for the Transport and Electronics business within that, after what was a pretty good Q2?

Mike Roman

It's probably good to step back. I recognize we've been seeing, the global economies slowing as we came through second quarter, but this is a trend that we've been seeing since late last year. And I would say if you look at now third quarter as we move sequentially forward to deliver on what Nick was just talking about, it really is a stabilization of the markets that we're facing and the trends that we're seeing. And to go below that it would have to – the economies would have to degrade even further.

And if you look at channel Nick talked about what we saw in the second quarter relative to the first quarter, we think when you look at the total year as it plays out a majority of the inventory adjustments in the channel are taking place in the first half. So it will be a lesser impact even though there'll be some impact in the second half. So that plus a easier comp as you get into Q3 if you look at it with our ERP deployment last year that would all add up to that trend.

And just on your question about TBG we would see them down in the second half from where they are in – sequentially from where they are in second quarter. But in line with the market outlook that we've talking we don't – I think early in the year people had been talking about, been hoping for a stronger recovery in automotive and electronics. But we see a more conservative view of that now with build rates down and continuing to be soft as we go into second half may be stabilizing a bit versus where they are in the second quarter, but still down. So we see sequentially down in TBG.

Julian Mitchell

Thank you.

Nick Gangestad

Hey Julian just to add a little bit what Mike said there for Transportation and Electronics in the third quarter particularly, we expect that to be down low to mid-single digits in the third quarter. And that's in line with what we're expecting as far as guidance for the full year for Transportation and Electronics. We've guided that we think for the full year that somewhere between flat to down 3%. And if I had to estimate right now, I'd say we're much – we're leaning more towards the low end of that range for Transportation and Electronics for the full year.

Julian Mitchell

That's extremely helpful. Just following-up on that Nick, as you said, that's trending towards the lower end. Also I think from a regional standpoint you took down your China assumption for the year. So maybe help us understand in the context of the overall reaffirmed organic sales growth guide for 3M for 2019 which of the regions or segments that are coming in maybe at the higher end or looking a little bit brighter today than back in April?

Nick Gangestad

Yes, so healthcare as far as the guidance that we've given for the full year on that, that's when we see more likely in the high end of the range; and Transportation and Electronics more likely towards the low end; Consumer. I'd put right in the middle of the range that we've laid out. And the SIBG we see it in the range, but that also could be in this bottom half of the range. And as we guided a negative one to plus two for the full year, last quarter and as we're affirming it, there was also a sense that we had there may be some places where things come in a little weaker and we're seeing that happen and that gives us the ability to continue to maintain that guidance, going forward.

Julian Mitchell

Perfect. Thank you.

Operator

Our next question comes from the line of Nigel Coe of Wolfe Research. Please proceed with your question.

Nigel Coe

Thanks. Good morning.

Nick Gangestad

Hi, Nigel.

Mike Roman

Hi, Nigel.

Nigel Coe

Hi. Just want to keep kind of follow-on that one really. Just kind of think about what the all means to that minus one plus two. So, it seems like you sort of biased in towards slightly below the midpoint based on what you see today, would that be fair, Nick, sort of looking at maybe flat to up slightly for the full year?

Nick Gangestad

Yes Nigel, I mean the midpoint of that range is up 50 basis points, so flat to up 50 to a 100 basis points, like that's I think of very fair zone for where our most likely landing spot is.

Nigel Coe

Okay, that's helpful. I'm not sure I missed some of the prepared remarks. Did you quantify the impacts of inventory headwind this quarter? So that down 90 bips, what was the sell through that you saw, excluding inventory headwinds?

Nick Gangestad

Now there's, Nigel, there's two different inventory points we talked about on channel inventory contractions that last quarter in the first quarter we said it was about a 100 basis point impact to revenue. We think second quarter was something similar to that. And Mike also clarified that we think well we still have some ahead of us for channel contraction, we think the majority is behind us. In terms of within our company as we have been reducing inventories ourselves, reducing our production, we've said that – I've said that we think that impacted our margin in the second quarter by a 100 basis points to 150 basis points.

Nigel Coe

Okay. That's very clear. Thanks for the detail. And my follow-on question is really on the location and implications of some of the one time of this quarter. There was $0.07 tax gain, did that land in the tax line or was that somewhere else Nick?

And then secondly, the restructuring is 1.12 operating, 3.6 non-operating. The payback was based on $0.20 of restructuring. Is that the right way to think about it or does the payback sort of come down because some of it is non-operating and maybe just touch on the nature of that non-operating restructuring charge.

Nick Gangestad

Okay, Nigel I'll just parse out the two pieces you're asking about, the $0.07 benefit we incurred in relation to the held for sale status for our Gas Detection business, that ran through the tax line, the income tax line of our income statement. The $148 million

impacting our operating expense and the balance $36 million of non-op. And that's exactly in line with what we were expecting. We were estimating approximately $150 million. The fact that some of it is hitting non-op versus operating doesn't impact at all the projected benefits we have going forward of approximately $110 million yet this year and on an annualized basis, $225 million to $250 million.

As far as where that restructuring happened, I would say geographically it happened around fairly well dispersed around 3M. And as far as business of the $112 million that was in operating expenses of that restructuring, about 75% of that was in our corporate and unallocated section, and about 25% of that was in our businesses. Now the benefit, that $110 million of benefit, that will be felt by our businesses through the second half of the year and it will be fairly proportionate to the size of each of our businesses as far as the benefits that you'll see in the second half.

Nigel Coe

Great. Thanks Nick.

Operator

Alright, next question comes from the line of Josh Pokrzywinski of Morgan Stanley. Please proceed with your question.

Josh Pokrzywinski

Hi. Good morning guys.

Nick Gangestad

Good morning Josh.

Josh Pokrzywinski

Nick, just a point of clarification on the inventory de-stock that you saw externally by your customers. You said that 100 basis points in the first quarter kind of look similar in the second quarter. But auto, I think, China auto specifically got better. So within that something must have gotten worse. Where did we see that get worse?

Nick Gangestad

As far as anything that got sequentially worse versus the first quarter Josh, nothing comes out particularly strong. I think in aggregate in China we continue to see China destocking on a more broad basis. So we didn't see it in our automotive business of any significance.

What we saw across our Safety and Industrial business that view Josh was very similar in terms of the total destocking impact that we were seeing of a 100 basis points both quarters.

Josh Pokrzywinski

Got it. That's helpful. And then I know it's a little early to think about 2020 but I guess thinking back with historical context for how destocking and re-stocking cycles go, should we expect to just be selling to kind of market demand as we get to the end of this? Or presumably in China there's kind of a bit of rational exuberance on both sides of the equation that as soon as things turn destock turns into restock. Has that historically been the case or should we just think about 2020 starting point as, hey, maybe we will lose some of that destocking headwinds?

Nick Gangestad

Yes, Josh, maybe a couple things. If you look at the channel and I would say the value chains, customer value chains, they react to the dynamics in the end markets pretty quickly. What you saw in the destocking the first half, they were reacting quickly to the build rates and automotive electronics. We expect that to stabilize in the second half. We'll see some additional destocking because of some of the slowing that we saw in second quarter, but it'll stabilize. So really to start to think about what happens in 2020 or even late in the year, it will depend on the end market dynamics. If they recover and their demand goes up, then you would see a pretty strong turnaround in restocking. But if it stabilizes and the projections and outlooks economically are more stable in the second half, then it would be balanced as we get into the second half. And then it depends on what happens in demand as we go into 2020.

Josh Pokrzywinski

Got it. That's helpful. And then just to follow-up on business transformation and the savings associated with that. Obviously there's a lot of moving pieces in the organization right now with restructuring, and some of the demand dynamics and the internal destocking. How are you benchmarking on some of the business transformation savings and kind of non-savings related kind of other benefits that would happen throughout the organization? Is that's something where those kind of go by the wayside or harder to execute on? Just an update on how that track.

Mike Roman

Yes we've always talked about transformation as a focus that starts and ends with a customer. But it is really making us more agile, more efficient and more competitive and that that creates value, all of those create value. And it also helped us realign the company around the four businesses, the go-to-market models of customers that we have. So it's enabling us to connect our customers even better as we move ahead. And it's a lot more than an ERP deployment. It's the entire ecosystem around that and it's digitizing our enterprise. All of that's adding efficiency.

And so we are committed to the savings that we talked about at the beginning, it’s the value realization that we would have by the end of 2020. But it does help us drive productivity. It does help us become more efficient broadly. And we talked about how that starts to show up in our margins over time. It's an enabler for us to continue to create premium margins as we move ahead. So it is going to be a driver of the savings that we've talked about, but also of that efficiency that will carry us forward.

Josh Pokrzywinski

All right. Thanks guys.

Nick Gangestad

Yes thanks Josh.

Operator

Our next question comes from the line of Steve Tusa with JP Morgan. Please proceed with your question.

Steve Tusa

Hi, good morning.

Mike Roman

Good morning Steve.

Nick Gangestad

Good morning.

Steve Tusa

The $0.07 of the tax benefit, I mean my tax line was relatively in line. Was there then a kind of a higher than expected effective tax rate and does that sustain itself? And also is that a $0.07 benefits kind of now in a run rate per kind of quarter here, or is that just kind of a onetime discreet item?

Nick Gangestad

Steve first of all, it's a – let me just describe it in a little bit of detail. The gas detection business that we own is in a position where we plan to sell it and the tax basis that we're holding that asset at is greater than the plan selling price. But it's also the book value of what we hold with that asset is below the plant's selling price. So when we sell it, we will take an operating income capital gain on that.

But from a tax perspective it will be a loss. Now I'm a bit over my skis here describing accounting nuances to you, but the accounting rules are, once you place this asset in a held for sales status if it's in a tax loss position, you take the tax benefit immediately even before the deal actually concentrates. So that $0.07 is a result of us putting it in that status. So that's not an ongoing repeating thing that will be seen.

As far as the underlying operations, no see there's not any big one thing offsetting that. There's always little nips back and forth in the tax rate. And the underlying tax rate for the full year we still think is going to be in the range of 20% to 22%.

Steve Tusa

Okay. And then gain when it comes to the divestiture, you said, that still $0.20 and that's still to come and not in the guidance.

Nick Gangestad

It's still not in the guidance.

Steve Tusa

Pre mature?

Nick Gangestad

Yes, that's still not in the guidance.

Steve Tusa

Okay. And then one last one, just on the second half are you planning for kind of there's a lot of things moving around, but are you planning, is this in your mind kind of normal seasonality for you guys for the second half of the year?

Nick Gangestad

Normal seasonality if I look at…

Steve Tusa

Normal.

Nick Gangestad

But the only thing that's abnormal is last year was a bit abnormal for us with some of our pull ahead sales into second quarter. So from a sequential basis we're not seeing this year progressing on an abnormal path. I think it'll be fairly normal.

Steve Tusa

Okay. And then just one last quick one, this $0.07 it's in the tax line, correct in the models that $0.07?

Nick Gangestad

That is correct, Steve.

Steve Tusa

Okay. Okay, great. Thanks a lot guys.

Operator

Our next question comes from the line of Deane Dray of RBC Capital Markets. Please proceed with your question.

Deane Dray

Thank you. Good morning everyone.

Mike Roman

Hey Deane.

Nick Gangestad

Hey Deane.

Deane Dray

Hey, the three problem areas that have been pressuring 3M for like more than past year auto electronics in China. So the China you called out has continued to be soft but notionally on a geographic basis is quarter it did not stand out as a particular negative. So can you comment on that and what kind of color you see across your businesses in China, in particular related to kind of the tariff and trade frictions?

Mike Roman

Yes, Dean, we do talk a lot about China auto electronics and kind of get them all together, but maybe just if you step back and look at China for 3M we continue to see strength in our healthcare business up high single digits. And so that was driving a strong growth for us. We also saw strength in our Medical Solutions business in particular. Transportation and Electronics was up low single digits in the quarter. We saw significant decline in Automotive OEM, but that was, countered offset by electronics up low single digits. We saw strong growth in our Transportation Safety business there and our Advanced Materials business. So there was some strength areas that helped trying to balance out.

As I said earlier, sequentially we see Transportation and Electronics a little softer in the second half. And so we're taking a conservative view around build rates in electronics outlook as we built our view of the second half. And that's part of impacting China. But second quarter, some strengths and a good performance against a strong comp year-over-year.

Deane Dray

That's helpful. And then on electronics, everyone wants to paint electronics all with the same brush, both product lines and geographies. But you made the comment earlier that display film was actually up and relatively strong and it was electronics material solutions that were softer. Maybe just share with us the nuances about why you would see those different dynamics within the supply chain. Maybe there's some semiconductor exposure there as well, but color would be helpful there.

Mike Roman

Yes I think that your last point is the place to start. Our electronic materials solutions business has a broader exposure in electronics, including semiconductor, fabrication, data centers, which continues to be a helpful market and growing. But it's got a little different

exposure. Display materials, certainly has the consumer electronics piece. The biggest part of the revenue there is consumer electronics, but we're also moving into higher growth areas like automotive electrification and we continue to see growth there. We continue to see some good results. And I would say consumer electronics, we saw a little bit of an uptick in displayed demand in second quarter, little stronger than maybe we even expected as we started into the quarter. Some of that is you start to see a little bit of buying in anticipation of the second half season for consumer electronics. And so we saw a little bit of that starting in second quarter. And that that hits display materials more so in a much bigger impact than in electronic materials.

Deane Dray

That's helpful. And just last one is more of a comment than a question is I really appreciate the comments about PFAS, and where that stands and the level of transparency that 3M is providing here. I'm just struck by how much misinformation is on the Internet regarding the chemical. Referenced it to being a forever chemical. And the reality is there are a number of very effective ways to remediate the chemical from water. They're all proven to be effective. The question of how much you want to spend, how big is the water body and your timeframe. So the remediation on this looks like it's doable and you all are taking an appreciated approach to this. So just wanted to have that.

Mike Roman

Yes thank you Deane. And we understand the concerns people have about their water. We take the issue seriously, but we're also seeing that we can make a difference in remediation and we'll continue to be transparent and update you as we go ahead.

Deane Dray

Thank you.

Operator

Our next question comes from the line of John Inch of Gordon Haskett. Please proceed with your question.

John Inch

Thanks everyone. Good morning.

Mike Roman

Good morning John.

Nick Gangestad

Good morning John.

John Inch

Nick just to clarify. So the $0.20 when you say it's not in the guide, just to be clear, the $9.25, $9.75 would not include the $0.20 of pending gain from the sale of gas and flame. Is that correct?

Mike Roman

John that's correct. It does not include the pending gain from the sale of our gas detection business, nor does it include any impact that will come from Acelity when and if that in and when and if that closes which we expect will be later this year.

John Inch

Right. And then Nick in the P&L the other expense income line of minus $256 million versus $51 million a year ago, I'm assuming Venezuela charge of $162 million is in that. And is the delta, the $36 million of nonop restructuring kind of getting you to $58 million? And does that number run through – doesn't look like it’s running for the adjusted number, but maybe you can help me with just the bridge there.

Nick Gangestad

Yes, that other, that will include the Venezuela, will also include $36 million from the restructuring actions we took that were not part of operating expense, those were the two biggest things in there.

John Inch

There's nothing else in there as consequences. And $36 million does run through, as a cost, runs through the adjusted number, is that correct?

Nick Gangestad

That is correct. That is correct.

John Inch

Okay. Are there any, just while we're on gas and flame, are there any other businesses, I guess this was part of safety, right? Was there any other businesses Mike or Nick that you're looking at that may be potential candidates for divestiture?

Mike Roman

John, portfolio management is one of our top priorities and as you know it's been ongoing process for us. And we're actively managing this aspect of the portfolio and their fit with our value model. We've shown that when we don't have the right fit, we'll take action. But that's something ongoing process we'll keep you updated.

John Inch

I guess my question is, would – did this just come about? Or were you've been working on it for a little while, or what was the genesis of it?

Mike Roman

This particular case, the gas detection business, when we made the acquisition of Scott Safety, this was part of our strategy at the time of acquisition. So this was we've talked about on portfolio how we think about complementing our organic priorities with acquisitions that leverage our fundamental strengths. Scott Safety was one of those, moves us into a high value space. And gas detection we identified that early that wasn't part of our strategy and now we're acting on it.

John Inch

Got It. And then just a couple more cleanups. I think you said – maybe Nick can you just update us on your expectation for share repurchase in the second half? And then I think you raised the dividend by 6% in the first quarter. Maybe Mike, philosophically you've got a lot of – you got a few pressures on your cash call at the moment. Are you committed still to an annual dividend increase kind of looking out?

Nick Gangestad

Yes John, let me take that. First, as far as the dividend our position for many several years has been that we expected to grow, our dividend to grow in line with earnings over time. Now this particular year is with the 6% increase that's outstripping our earnings growth, but the concept of us continuing to increased earnings our dividends year-over-year, I'd

say that's a philosophy and approach we continue to expect. But I would say as far as expecting a dividend increase that over time it will parallel fairly closely our earnings per share growth.

And then John remind me of the first part of the question.

John Inch

Sorry share repurchases.

Mike Roman

Share repurchase, yes.

Nick Gangestad

I've guided $1 billion to $1.5 billion for the full year. That would imply at most just a few hundred million in the second half of the year.

John Inch

And, I'm sorry for this last point. Obviously the earnings are going down, is the philosophy you grow dividends with earnings, but if your earnings are going down, are you just going to hold the dividend, or and then wait for the catch up? Is that kind of the implication? I'm not actually trying to hold you to a number I'm just trying to understand the philosophy.

Nick Gangestad

No, the philosophy would be over time. I would think unlikely that we would decrease full flat or decrease a dividend even if there was one year of an earnings decline. If I go back to other times in our history where we've had an earnings decline, we still have some small increases in our dividend.

John Inch

Got it. Thank you very much. I appreciate it.

Operator

Our next question comes from the line of John Walsh of Credit Suisse. Please proceed with your question.

John Walsh

Hi, good morning.

Mike Roman

Good morning John.

Nick Gangestad

Good morning John.

John Walsh

So in the prepared remarks you kind of talked about higher pricing being able to offset inflation for the full year. Just want to pull apart that price piece and just we've seen a deceleration right for the full year on an absolute basis.

Nick Gangestad

Yes, I'll go even further John. So we've averaged about 70 basis points of price growth in the first half of the year. My best estimate for the full year is we'll be right in that range. So I wouldn't characterize it as a deceleration. I think about 70 basis points first half. I think something in the range of 70 basis points that can have is our best view on that now. And remain quite confident that it will more than outpace what we're seeing from a raw material and tariff inflation impact.

John Walsh

Got you. And then just thinking about the third quarter organic growth the flat to up low single digits that still implies that the growth on growth would decelerate because you have an easier comp in Q3 of 2018, just maybe some color that you saw exiting the quarter, June, July, anything you can kind of talk to as the trajectory seeing currently.

Nick Gangestad

John's the biggest trajectory change that I'll say that that colors the flat to up low-single digits in the third quarter as far as versus a comp is my earlier statement that we expect Transportation and Electronics to be down low to mid-single digit. I think that will be the thing that colors why sequentially versus an easier comp it's not quite the same level of growth you would expect. When I look across the rest of our businesses your analysis you just went through, I think, is a pretty valid analysis.

John Walsh

Great, appreciate it. Thank you.

Mike Roman

Yes thanks John.

Operator

Our next question comes from the line of Laurence Alexander of Jefferies. Please proceed.

Laurence Alexander

Good morning. I have two quick ones. Can you just give a little bit more detail on what trends you're seeing in aerospace, it seemed a bit weaker than what we've heard from other companies.

And secondly, on PFAS or PFOS and PFOA, that litigation area, can you characterize whether the U.S. standards are tougher or easier than in Europe? And maybe just sort of help us get in front, get ahead of where the food contactor base is because I think that that's like another cloud of noise that shouldn't really be affecting you. But I think sort of people are, sort of focused on the European side there?

Mike Roman

Yes, Lawrence maybe starting with aerospace when we talked about the business we talked about Automotive and Aerospace together as one business and when you look at the divisions that we share and that we report the revenue from its together. Our aerospace business actually has shown some good growth as we come through the first half of the year. So it's smaller than our automotive business, but it's an important business for us in doing well. So I don't think we're saying anything different, in that respect.

What I would say about, thinking about Europe versus U.S. and PFAS or PFOA, PFOS regulations, the regulations are really evolving right now. I don't think it's clear to – I don't think I can clearly compare U.S. versus other international Europe regulations it’s very evolving and we're working with regulators broadly both federal and local.

Laurence Alexander

Okay. Thank you.

Operator

Our next question comes from the line of Jeff Sprague of Vertical Research Partners. Please proceed with your question.

Jeff Sprague

Thank you. Good morning fellows.

Nick Gangestad

Hi, Jeff.

Mike Roman

Hi, Jeff.

Jeff Sprague

Hey obviously a lot of ground covered. I thought it might be interesting to just flip the script a little bit to things that look okay or a little bit better. So in particular your confidence level and consumer maybe being kind of middle of the guy, healthcare may be better. Just a couple finer points on what you see going on there what would drive that? Where are we at in kind of the drug delivery, comps, et cetera?

Mike Roman

Yes, so I would say if you look at healthcare, we talked about at a good quarter. And behind that is a strong market growth. So this was a – we're not a place where we got good market dynamics and our businesses are performing well. We had our biggest business, our Medical Solutions business, up mid single digits, we saw strength in the U.S. we saw strength in China as I talk about it.

Our food safety business was up mid-single digits, our Health Information Systems business was up high single digits. So it's pretty broad-based performance as we went through the quarter. We did see a decline in drug delivery as we expected in mid-sing digits in Q2. We're talking about how we see that stabilizing as we go through 2019 and we do see some improvements sequentially as we go into the second half in that business. So that will actually help the overall performance of the Health Care business. So second half we also have the same comparables year-over-year dynamic. We have a little easier comparable in the second half. So strong market dynamics, a portfolio performing well, broadly and I think, a strong of performance against comps in the second half.

You look at Consumer we're at 1% and as Nick's comments said, kind of the middle of the range as we look for the total year. If we look, we got good balance between our sell in and sell out. And all of our businesses in the second quarter were growing with exception of our home care business. And we see that sell out dynamic setting up a good middle of the range kind of performance in the second half against some growth in retail spending in the macro.

Jeff Sprague

Is there anything that conclude or any comp issue as it relates to that home care business? What was actually going on there?

Mike Roman

I think we saw maybe a little bit of a comp year-over-year we had some of the same go-live of the U.S. ERP deployment impacting that business. And I would say consumer is larger in the U.S. than some of our other businesses. About half of our global revenue is in the U.S. So it's a bigger footprint. So it has a slightly higher impact when you have that pull ahead, and it did impact all of those businesses in 2018.

Jeff Sprague

Alright, thank you guys.

Nick Gangestad

Yes thanks Jeff.

Mike Roman

Thanks Jeff.

Operator

That concludes the question-and-answer portion of our conference call. I'll now turn the call back over to Mike Roman for some closing comments

Mike Roman

To wrap up, I am encouraged by our Company's progress in the second quarter. Our execution was strong in the face of continued slow growth conditions and key end markets. As we effectively managed costs and improved our cash flow. Moving ahead and

we remain focused on continuing to drive operational improvements, investing for the future and delivering for our customers and shareholders. Thank you for joining us.

Operator

Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your line.

Comments (0)